# Asset Location: Seek Higher After-Tax Returns

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*Choosing the right account can help you keep more of your investing gains.*

In real estate, it's location, location, location that often counts most. And in investing, the same bit of wisdom also has a place. Where you put your investments—meaning the type of account you choose—can make a major difference in how much you can earn, after tax, over time.

Should you use your brokerage account for the REIT fund you are investing in, or would that be better in your tax-deferred annuity? What about the growth stocks you have been eyeing or the municipal bonds you are laddering toward retirement income—should those go into a Roth or into your taxable account?

"You can't control market returns, and you can't control tax law, but you can control how you use accounts that offer tax advantages—and good decisions about their use can add significantly to your bottom line," says Matthew Kenigsberg, senior quantitative analyst in Fidelity Strategic Advisers. This type of strategy is often referred to as active asset location.

### How an active asset location strategy works

Let's look at a hypothetical example (illustrated below). Say Adrian is thinking about investing $250,000 in a taxable bond fund for 20 years. For this example we will assume Adrian pays a 36.8%* marginal income tax rate and earns a 6% rate of return each year—before taxes. (Actual rates of return may be lower.) But what account will he hold the investment in? The answer matters. If he chooses a tax-deferred account—in this example a no-fee tax-deferred IRA—his liquidation value could be nearly $75,000 greater than in a taxable account.

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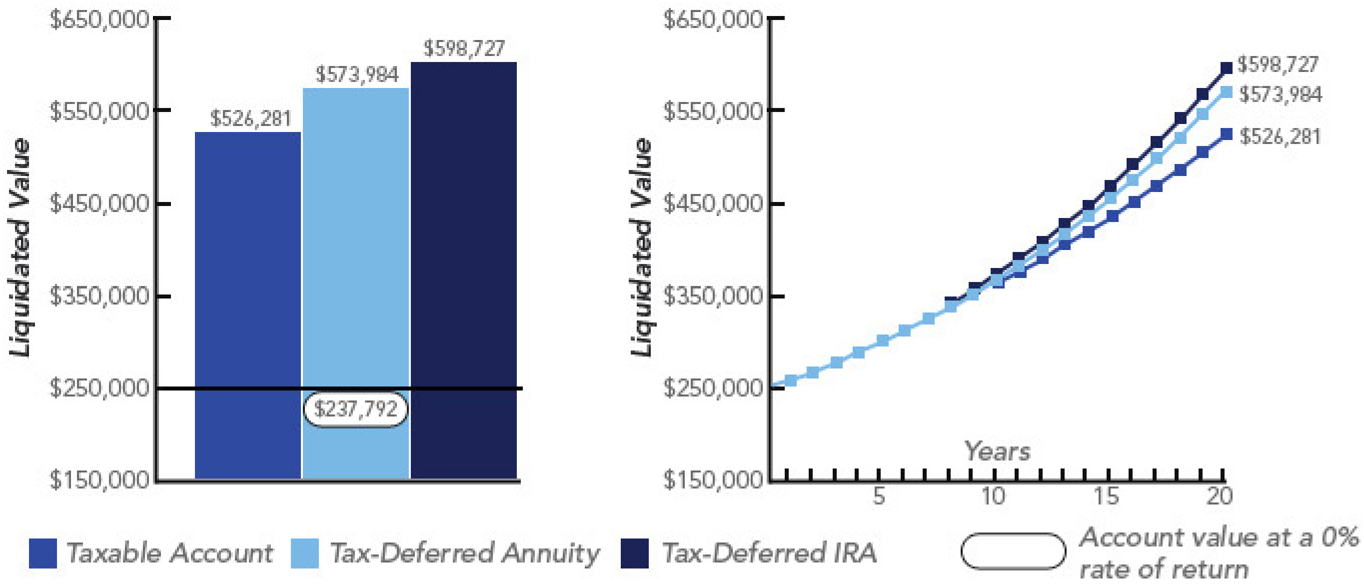
**Asset location has the potential to impact after-tax performance**

The account location of an investment may make a difference for an investor. Look at the liquidated value of a hypothetical $250,000 bond fund investment after 20 years in a taxable account, a deferred variable annuity with 0.25% annual fee, and a no-fee tax-deferred IRA (see disclosure for details).




**This hypothetical example is not intended to predict or project investment results. Your actual results may be higher or lower than those shown here.** Assumptions include:

$250,000 investment, 20-year time horizon, 0.25% annual annuity charge for the tax-deferred variable annuity (VA), marginal federal income tax rate of 36.8% (33% ordinary income tax plus 3.8% Medicare surtax) for the entire period, and a 6% annual rate of return (equivalent to a 5.74% net annual rate of return for the VA) with the gain assumed to derive entirely from income (characterized for tax purposes as ordinary income). Investments that have the potential for a 6% annual rate of return also come with the risk of loss. This rate of return is not guaranteed.

In the taxable account it is assumed taxes incurred on the income are paid annually from the income itself, with the remainder reinvested. In the tax-deferred account, it is assumed that all income is reinvested. For the VA, it is assumed that all income—less the 0.25% annual annuity charge—is reinvested. It is assumed the investor liquidates the VA and the tax-deferred account at the end of time period, and pays taxes on the gains out of the proceeds. If the assets in these accounts were liquidated entirely in one year, the proceeds may increase the tax bracket to the marginal federal income tax rate of 43.4% (39.6% ordinary income tax plus 3.8% Medicare surtax), which would minimize and potentially eliminate any savings. To avoid this, the VA and tax-deferred account would need to be liquidated over the course of several years or annuitized, which would lengthen the deferral period.

State and local taxes, inflation, and fund and transaction fees were not taken into account in this example; if they were, performance for the taxable account, the variable annuity, and the tax-deferred account would be lower. This example also does not take into account capital loss carry forwards or other tax strategies that could be used to reduce taxes that could be incurred in a taxable account; to the extent they apply to your situation, the comparative advantage of the variable annuity and tax-deferred account would be diminished. Lower tax rates on interest income would make the taxable investment more favorable. Changes in tax rates and tax treatment of investment earnings may impact the comparative results. Consider your current and anticipated investment horizon and income tax bracket when making an investment decision, as the illustration may not reflect these factors.

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The year-by-year account value for the taxable account shown above is: $259,480 for year 1, $269,319 for year 2, $279,532 for year 3, $290,132 for year 4, $301,134 for year 5, $312,553 for year 6, $324,405 for year 7, $336,706 for year 8, $349,474 for year 9, $362,726 for year 10, $376,481 for year 11, $390,757 for year 12, $405,574 for year 13, $420,954 for year 14, $436,916 for year 15, $453,484 for year 16, $470,680 for year 17, $488,528 for year 18, $507,053 for year 19, and $526,281 in year 20. The year-by-year value after federal income taxes have been deducted for the VA with 6% return less the 0.25% annual annuity charge shown above is: $259,061 for year 1, $268,642 for year 2, $278,773 for year 3, $289,484 for year 4, $300,810 for year 5, $312,785 for year 6, $325,447 for year 7, $338,835 for year 8, $352,991 for year 9, $367,959 for year 10, $383,785 for year 11, $400,519 for year 12, $418,213 for year 13, $436,921 for year 14, $456,702 for year 15, $477,618 for year 16, $499,733 for year 17, $523,117 for year 18, $547,841 for year 19, and $573,984 in year 20. The year-by-year value for the VA at a 0% annual return less the 0.25% annual annuity charge is: $249,375 for year 1, $248,752 for year 2, $248,130 for year 3, $247,509 for year 4, $246,891 for year 5, $246,273 for year 6, $245,658 for year 7, $245,044 for year 8, $244,431 for year 9, $243,820 for year 10, $243,210 for year 11,$242,602 for year 12, $241,996 for year 13, $241,391 for year 14, $240,787 for year 15, $240,185 for year 16, $239,585 for year 17, $238,986 for year 18, $238,388 for year 19, $237,792 for year 20.

VAs are generally not suitable for investors with time horizons of less than 10 years, as in most cases there is little to no advantage over a taxable account for the first 10 years of the investment.

As you can see, tax deferral has the potential to make a big difference for investors—especially when matched with investments that may be subject to significant taxation. As illustrated in the hypothetical example above, qualified accounts such as IRAs, 401(k)s, 403(b)s or other workplace savings plans, may provide the greatest benefits in an asset location strategy. But investors who have already maximized those options or may not be eligible for them, may want to consider deferred annuities, which charge additional fees and may be subject to different withdrawal rules, but can provide an additional option for tax-deferred saving.

## Can you benefit from an active asset location strategy?

Many investors have several different types of accounts. Some are subject to taxes every year and others have tax advantages. Typically, restrictions on contributions or withdrawals prevent investors from simply saving everything in tax-advantaged accounts. So how do you decide what to put where?

There are four main criteria that tend to indicate if an active asset location strategy would be a smart move for you. The more these criteria apply to your situation, the greater the potential advantage in after-tax returns.

- **You pay a high marginal income tax rate:** The higher the marginal income tax rate you pay, the bigger the potential benefits of active asset location. If you are in one of the highest three federal tax brackets or live in a city or state with high income taxes, a strategy to help make the location of your investments more tax efficient could be an easy way to boost your after-tax returns without assuming additional risk.

- **You expect lower income taxes in retirement:** If you plan to move to a state with much lower income taxes or expect to be in a lower tax bracket due to reduced income after you stop working, or both, an investment strategy designed to take advantage of additional tax deferral now can have a big impact later. That's because in addition to delaying taxation—which has significant benefits of its own—you will also pay taxes at a lower rate in the future.

- **You have a lot of tax-inefficient investments in taxable accounts:** The more tax-inefficient assets you're currently holding in taxable accounts (see below), the greater the potential to take advantage of active asset location.

- **You expect to be invested for more than 10 years:** Active asset location strategies generally take time to work (as a general rule, they require at least 10 years to be effective). The longer you can keep your assets invested, the greater the potential benefits from tax deferral. So if you are saving for retirement and expect to work at least another 10 years or won't need to use the money in your tax-advantaged accounts any sooner than that, an active tax location strategy could have a big impact. Note, however, that under some circumstances—such as a sharp drop in income or a move from a domicile with high state or local taxes to one with none—active asset location can have an effect in less than 10 years.

## First, rate your investments on a tax-efficiency scale

If you are in position to take advantage of an active asset location strategy, you have to choose which assets to keep in your tax-advantaged accounts and which to leave in your taxable accounts. This is where being selective can make the biggest difference.

The more tax inefficient an investment is, the more tax you pay on it. Below, we rate a variety of investment types across a spectrum from very inefficient to very efficient. Of course, there is no way to know exactly what tax rates will apply to your investments in the future, but in general:

- **Bonds,** with the exception of tax-free municipal bonds and U.S. saving bonds, are generally highly tax inefficient. Potentially higher-returning more volatile types of fixed-income investments are the most tax inefficient.

- **REITs** are also rated low on the tax efficiency scale. That's because they are required by law to pay out at least 90% of their taxable income, and, unlike other equities, this income is generally taxed at higher, ordinary income, rates.

- **Stocks** are, as a general rule, relatively tax efficient. That's because qualified dividends and capital gains on the sale of stocks held a year or more are currently taxed at a top rate of 23.8% (this includes the top long-term capital gain rate of 20% plus the 3.8% Medicare surtax on net investment income). Less-affluent investors would pay rates of 18.8%, 15%, or even in some cases 0%. Equity-based exchange-traded funds (ETFs) are essentially taxed like stocks. However, note that the return of phaseouts on itemized deductions in 2013 could, in an indirect way, drive the marginal tax rate you pay on stocks slightly higher if you're a high-income earner.

The story with stock mutual funds is more complex. While stock index funds are generally quite tax efficient, many actively managed stock funds are tax inefficient because of high turnover rates. They can distribute short-term capital gains, which are taxed at the higher ordinary income tax rates. Although it is difficult to make generalizations about which actively managed funds are more or less tax efficient, as you can see in the graph below, large-cap funds have historically tended to be more tax efficient on average than otherwise similar small-cap ones (recently, foreign value funds have been an exception to this rule).

**Tax efficiency of stock mutual funds**

| Morningstar Category | Tax cost ratio† (10-year) |
|---|---|
| Large Growth | 0.24 |
| Large Blend | 0.58 |
| Large Value | 0.87 |
| Foreign Large Value | 0.99 |

†See the Tax Cost Ratio section in the endnotes. Data as of 9/30/12. Source: Morningstar. The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Mutual funds regularly distribute stock dividends, bond dividends, and capital gains to their shareholders. Investors must then pay taxes on those distributions during the year they were received. See disclosure for more information.

| Morningstar Category | Tax cost ratio† (10-year) |
|---|---|
| Foreign Large Growth | 0.52 |
| Small Growth | 0.58 |
| Small Blend | 0.88 |
| Small Value | 1.06 |
| Foreign Sm/Mid Value | 0.84 |
| Foreign Sm/Mid Growth | 0.97 |

†See the Tax Cost Ratio section in the endnotes. Data as of 9/30/12. Source: Morningstar. The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Mutual funds regularly distribute stock dividends, bond dividends, and capital gains to their shareholders. Investors must then pay taxes on those distributions during the year they were received. See disclosure for more information.

### Then, locate your investments where they may help enhance after-tax returns

So, which investments do you put where to help maximize after-tax returns? Each person will have to find the right approach for his or her particular situation. But generally you may want to consider putting the most tax-efficient investments in taxable accounts and the least in tax-deferred accounts.

**Trying to match investments and accounts**

In general, the less tax efficient an asset is, the more you may want to consider putting it in a tax-deferred account like a traditional IRA, 401(k), or deferred annuity, or a tax exempt account such as a Roth IRA.

More appropriate M Appropriate A Less appropriate L

| | Tax Treatment of Expected Return | Taxable | Tax-Deferred | Tax Exempt |
|---|---|---|---|---|
| Tax-free municipal securities and mutual funds | Exempt | M | L | L |
| Equity securities held long-term for growth | Taxed at Long-Term Capital Gain Rates | M | A | A |
| Equity index funds/ETFs (other than REITs) | | M | A | A |
| Tax-managed equity mutual funds and SMAs | | M | A | A |
| Real estate investment trusts (REITS) | Taxed at Ordinary Income Rates | L | M | M |
| High-turnover stock mutual funds that deliver effectively all returns as short-term capital gains | | L | M | M |
| Fully taxable bonds and bond funds (i.e.,corporates) | | L | M | M |

For illustrative purposes only.

To get going, consider first checking to see whether you've already taken full advantage of a 401(k) plan, Keogh, IRA, or other qualified account that may be available to you for free. Generally, these accounts are the best place to start a program of active asset location, but each comes with contribution and withdrawal restrictions.

Once you have maxed out those options, you might think about assigning any clearly tax inefficient assets remaining in your taxable accounts to a low-cost tax-deferred variable annuity, so they too may benefit from tax-deferred growth potential. When choosing to invest in an annuity, you need to consider the costs, contribution restrictions, and the rules concerning how and when you can access your money.

"Deferring taxes may improve your bottom line as an investor," says Kenigsberg. "That's why having a good strategy for where you keep your investments can be so important."

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**Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact your investment professional or visit advisor.fidelity.com for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.**

*The marginal income tax rates listed here include both the marginal income tax bracket (33%) and the Medicare surtax on net investment income of 3.8%.

**Tax Cost Ratio**
The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Mutual funds regularly distribute stock dividends, bond dividends, and capital gains to their shareholders. Investors must then pay taxes on those distributions during the year they were received.

Like an expense ratio, the tax cost ratio is a measure of how one factor can negatively impact performance. Also like an expense ratio, it is usually concentrated in the range of 0%–5%, where 0% indicates that the fund had no taxable distributions and 5% indicates that the fund was less tax efficient.

For example, if a fund had a 2% tax cost ratio for the three-year time period, it means that on average each year, investors in that fund lost 2% of their assets to taxes. If the fund had a three-year annualized pretax return of 10%, an investor in the fund took home about 8% on an after-tax basis. (Because the returns are compounded, the after-tax return is actually 7.8%.)

The tax cost ratio provides additional information that is not available from after-tax returns alone.

Per the SEC's guidance, after-tax returns reflect both tax effects and sales loads. The tax cost ratio isolates the effects of taxes alone.

Different categories of funds and different time periods will have varying levels of pre- and after-tax returns. The tax cost ratio is independent of the level of the return and it is always expressed on an annualized basis. Therefore, it can be used to compare different funds, categories, managers, and time periods. For example, you can compare the three-year and 10-year tax cost ratios for the same fund to see if the manager has become better at managing tax issues in more recent years.

Morningstar calculates the tax cost ratio in-house on a monthly basis, using load-adjusted and tax-adjusted returns for different time periods. Morningstar uses the tax-adjusted return that is called "pre-liquidation after-tax return," which is also known as "return after taxes on distributions." Morningstar calculates this statistic for open-end mutual funds, exchange-traded funds, and variable annuity underlying funds based in the United States.

**Assumptions**
Because the tax cost ratio is based on after-tax returns, it is based on the same assumptions as those returns and it is an estimate of what the hypothetical investor would experience. For example, after-tax returns assume that investors pay the maximum federal tax rate on capital gains and ordinary income.

**Calculation**
The tax cost ratio for time i, Ti, is
Ti = 1 – (1 + ATRi)/(1 + Li)
where
ATRi = annualized pre-liquidation after-tax return for the time period i. (This is also load-adjusted.)
Li = annualized load-adjusted pretax return for the time period i
The tax cost ratio is a positive expression of a negative rate of return that is due to taxes. By rewriting the equation, it is apparent that the after-tax return is the same as compounding the load-adjusted return and the tax cost ratio negative return.
(1 + ATRi) = (1 + Li)(1 – Ti)
(1 + after-tax return) = (1 + load-adjusted return) (1 + negative rate of return for taxes, i.e. tax cost ratio)

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Withdrawals of taxable amounts from an annuity are subject to ordinary income tax, and, if taken before age 59½, may be subject to a 10% IRS penalty.

**Investing in a variable annuity involves risk of loss; investment returns and contract value are not guaranteed and will fluctuate.**

In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Exchange-traded products (ETPs) are subject to market volatility and the risks of their underlying securities, which may include the risks associated with investing in smaller companies, foreign securities, commodities, and fixed income investments.

Changes in real estate values or economic conditions can have a positive or negative effect on issuers in the real estate industry, which may affect the fund.

Investing in small-cap stocks may have a greater risk because they are subject to abrupt or erratic price fluctuations.

***As with all of your investments, you must make your own determination whether an investment in any particular security or fund is consistent with your investment objectives, risk tolerance, financial situation, and your evaluation of the investment option. Fidelity is not recommending or endorsing any particular investment option by mentioning it in this presentation or by making it available to its customers. This information is provided for educational purposes only, and you should bear in mind that laws of a particular state and your particular situation may affect this information. There is no guarantee the trends discussed here will continue. Investment decisions should take into account the unique circumstances of the individual investor.***

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